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IN THE

Supreme Court of the United States

OCTOBER TERM, 1930.

No. 759.

THE UNITED STATES, *Petitioner*,

vs.

KIRBY LUMBER COMPANY.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI.

QUESTION PRESENTED.

Does a corporation realize taxable income when it discharges a debt prior to maturity by payment of a lesser sum than that called for on the face of the bonds which represent the debt?

STATEMENT.

July 16, 1923, the Kirby Lumber Company made a deed of trust on certain of its property to secure the

payment of certain bonds. $12,126,800 of the said bonds were issued at par (Findings 4 and 7, R. 12). (The bonds were not issued for cash, as stated by petitioner, but were exchanged for preferred stock on the lowest permissible basis, a price of $105 per $100 share and accrued dividends of $126 per share, or a total of $231 per share.) During 1923 the Kirby Lumber Company purchased $1,078,300 par value of these bonds for $940,778.70, or $137,521.30 less than the issuing price, and retired the said bonds so purchased (Finding 5, R. 12).

REASONS WHY PETITION SHOULD BE DENIED.

The petition should be denied for the following reasons:

1. The Kirby Lumber Company did not receive "income" within the meaning of the Sixteenth Amendment.
2. The principle involved has been decided by this Court.
3. There is no conflict of decisions on the point involved. To the contrary, there is a long line of decisions sustaining the decision of the Court below.
4. The petition misstates a material fact.
5. The Government's position is not sound.

ARGUMENT.

The transaction here involved is nothing more nor less than the payment of a debt. Any effort to make more out of the case merely tends to confuse the issue and is not supported by the facts.

Only "Income" Can be Taxed.

The Sixteenth Amendment grants power to Congress to "lay and collect taxes on incomes, from whatever source derived."

The question in this case, therefore, is whether the item on which the taxpayer was taxed is "income," "from whatever source derived" under the Amendment. Unless it is "income," then, as a direct tax on personal property, without apportionment, its imposition on the taxpayer in this case would be beyond the powers of Congress as established by *Pollock v. Farmers' Loan and Trust Co.*, 157 U. S. 429.

"Income" has been repeatedly defined by this Court as:

1. Gain derived from capital;
2. Gain derived from labor;
3. Gain derived from capital and labor combined;
4. Profit gained through a sale or conversion of capital assets.

The Court in explaining this definition states:

> "* * * Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being *'derived'*, that is *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description." *Eisner v. Macomber*, 252 U. S. 189, 207.

It is difficult to make a better argument in the case at bar than to quote from the District Court opinion

in *Kerbaugh-Empire Co. v. Bowers,* 300 Fed. 938. At page 943 the Court states:

> "* * * Nothing has been severed from the plaintiff's capital as a result of this transaction which has come into the plaintiff. The improvement of the plaintiff's balance sheet is not income to the plaintiff. All that it had was a decrease in liability. * * *"

At page 945 the Court continues:

> "* * *. It seems clear that neither the Sixteenth Amendment nor the Revenue Act sought to levy an income tax upon anything except income as it was actually received, and under the Constitution and the Revenue Act of 1921 there can be no such thing as a negative income; the two words being inconsistent."

The very most which can be said of the transaction here involved is that the capital structure of the plaintiff was improved.

> "* * * enrichment through increase in value of capital investment is not income in any proper meaning of the term." *Eisner v. Macomber,* 252 U. S. 189, 214.

A somewhat similar situation to the one here presented is where debts of a taxpayer are, for one reason or another, cancelled. The earliest of these decisions is *U. S. vs. Oregon-Washington R. & Nav. Co.,* 251 Fed. 211, where the Court (C. C. A. 2nd) held adversely to the Government's contention stating (p. 212):

> "However, the tax, though it includes income 'from all sources,' nevertheless includes 'income' only, and the meaning of that word is not to be

found in its bare etymological derivation. Its meaning is rather to be gathered from the implicit assumptions of its use in common speech. The implied distinction, it seems to us, is between permanent sources of wealth and more or less periodic earnings. Of course, the term is not limited to earnings from economic capital; *i. e.*, wealth industrially employed in permanent form. It includes the earnings from a calling, as well as interest, royalties, or dividends, though in the case of corporations this may be of slight importance. Yet the word unquestionably imports, at least so it seems to us, the current distinction between what is commonly treated as the increase or increment from the exercise of some economically productive power of one sort or another, and the power itself, and it should not include such wealth as is honestly appropriated to what would customarily be regarded as the capital of the corporation taxed.

"Now, it seems to us hardly arguable that the cancellation of the debt in question was not in the category of capital. * * *"

This Court expressed the same thought in *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179, 185:

"* * * Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. * * *"

The Board of Tax Appeals, in many cases, has held that the cancellation of indebtedness does not result in taxable income. A few cases are:

Meyer Jewelry Co., 3 B. T. A. 1319;
John F. Campbell, Co., 15 B. T. A. 458;
Eastside Mfg. Co., 18 B. T. A. 461;
Progress Paper Co., 20 B. T. A. 234.

"The cancellation of the indebtedness, therefore, constituted a gift to the corporation or a contribution to its capital * * *." *R. E. Olds*, 18 B. T. A. 1215; 1220.

Principle Has Been Decided by This Court.

As the Court of Claims states (R. 14) the principle involved has been decided by this Court. In *Bowers v. Kerbaugh-Empire Co.*, 271 U. S. 170, 173, it is stated:

"The question for decision is whether the difference between the value of marks measured by dollars at the time of payment to the Custodian and the value when the loans were made was income."

In other words, the question in the Kerbaugh-Empire case was precisely the same as the question here presented—Does a corporation realize taxable income by paying a debt for a lesser sum in dollars than it was originally obligated to pay?

The petition in this case attempts to show that the Kerbaugh-Empire case decided an issue different from the issue stated by the Court and as quoted above. When the case was presented to the Court, however, the Government clearly stated the issue as follows:

"The question in this case is whether or not the profit or gain made by a corporation as the result of borrowing foreign money and later settling its debt at a rate of exchange lower than

that at which the loan was made is taxable income." Page 1, Government's brief in *Bowers v. Kerbaugh-Empire Co.*, No. 173, October Term, 1925.

In the Kerbaugh-Empire case the Government had a strong equity not here present, because the taxpayer had been permitted to deduct from prior years' income losses totalling $1,983,000 and yet the taxpayer was only out of pocket in the principal amount of $80,411.12 when the obligation was paid in 1921.

The Kirby Lumber Company did not have any deductible loss in 1923 or any other year as a result of the transaction. Instead, for each and every year after the $1,078,300 debt was paid, the payment of interest thereon ceased ($64,698 per annum), and the deductions from income in the tax return on account of interest payments were reduced in a like amount, resulting in additional tax payment.

There is no Conflict of Decisions on the Point Involved.

On the point here involved the Board of Tax Appeals has held in favor of the taxpayer. The following are examples:

Independent Brewing Co., 4 B. T. A. 870;
New Orleans, Texas & Mexico Ry. Co., 6 B. T. A. 436;
Houston Belt & Terminal Ry. Co., 6 B. T. A. 1364;
National Sugar Mfg. Co., 7 B. T. A. 577;
Petaluma & Santa Rosa R. R. Co., 11 B. T. A. 541;
General Manifold & Printing Co., 12 B. T. A. 436;

Chicago, Rock Island & Pacific Ry. Co., 13 B. T. A. 988;
American Seating Co., 14 B. T. A. 328;
Douglas County Light & Power Co., 14 B. T. A. 1052;
Eastern Steamship Lines, Inc., 17 B. T. A. 787;
North American Mortgage Co., 18 B. T. A. 418;
Kirby Lumber Co., 19 B. T. A. 1046;
Houghton & Dutton Building Trust, 20 B. T. A. 591;
American Tobacco Co., 20 B. T. A. 586;
Boulevard Building Co., 21 B. T. A. 864;
Norfolk Southern R. R. Co., decided Feb. 20, 1931;
Coastwise Transportation Co., decided Feb. 25, 1931.

The first of the decisions on the point was decided by the Board of Tax Appeals September 18, 1926. The Revenue Act of 1926, which became effective February 26, 1926, provided for appeal from the Board of Tax Appeals to the Circuit Courts of Appeal. Despite the many decisions cited above, the first appeal was filed December 19, 1930, when *Kirby Lumber Co.*, 19 B. T. A. 1046, was taken to the Fifth Circuit. February 4, 1931, the case of the *American Tobacco Co.*, 20 B. T. A. 586, was appealed to the Second Circuit.

The Government admits that it has "found no conflict of decisions upon the question here involved" (R. 5). If this Court is not going to be overwhelmed by being asked to decide nearly all issues which arise in the administration of the taxing laws it would seem that certiorari should not issue except to afford a uniform application of the law where a conflict of decisions exists.

The Petition Misstates a Material Fact Which is Misleading.

In the first paragraph of the Statement in the petition (R. 2) it is stated:

> "* * * For these bonds the Lumber Company received cash at par for each bond."

On page 4 of the Record, where an effort is made to bring this case within the language of *Burnet, Commissioner, v. Sanford & Brooks Co.*, 282 U. S. 359, the petition states:

> "In the instant case there is both (1) a clear gain or profit and (2) actual cash received during the year in excess of disbursements made or incurred."

Counsel fully realizes that the Government would not intentionally mislead this Court for the purpose of securing the writ which is sought. However, a most serious distortion of facts is presented in the foregoing quotations because the Kirby Lumber Company DID NOT RECEIVE CASH for the bonds here involved. The bonds were issued at par, as found by the Court of Claims (Finding 7, R. 12), but they were exchanged for preferred stock on the lowest permissible basis, a price of $105 per $100 share plus accrued dividends of $126 per share, or a total of $231 per share.

The bond issue simply resulted in a change in the capital structure of the corporation. Prior to the bond issue the balance sheet showed preferred stock as a liability, while after the bond issue the bonds were shown as the liability. There was no gain or profit, and no cash was received.

Government's Position is Unsound.

To illustrate the unsoundness of petitioner's contention suppose the A Corporation purchased a factory for $150,000 of which amount it paid $50,000 with cash in its possession, and $100,000 with money obtained from B and secured by a mortgage on the factory. Before maturity B became in need of funds and accepted $90,000 in full payment of the mortgage. Under the Government's theory the A Corporation would make a taxable gain of $10,000, despite the fact that the transaction resulted in a total outlay by the A Corporation of $140,000. The next step in this theory is that if the A Corporation sold its factory for $140,000 in cash it would lose $10,000. Such reasoning is obviously not the law.

In *Des Moines Improvement Co.*, 7 B. T. A. 279, the taxpayer executed second mortgages totalling $45,000. The holder of the mortgages cancelled them upon receiving $33,200 in cash. The Board held the $11,800 difference between the face value of the mortgages and the sum necessary to retire them was not income. The Commissioner of Internal Revenue acquiesced in this decision (C. B. June 1929, p. 12).

The Government's position in this case is somewhat confused, but apparently it is that income was realized when the bonds here involved were "purchased." As stated, the transaction, in reality, was the payment of a debt. It is obvious, of course, that income cannot be realized by the purchase of anything. When income is made as the result of a capital transaction it is by "the sale or other disposition" of a capital asset. It is significant that the petitioner has not cited a single case where taxable profit is realized

by purchase. If income could be realized by purchase every "good bargain" would be taxable to the purchaser when the purchase was made, and the labyrinth of tax law would, indeed, become endless.

Importance of Point Involved.

No attempt will be made to answer the argument that the writ should issue because cases on the point pending in the Bureau of Internal Revenue involve $10,000,000. Unquestionably the Court will decide the case on the law of the point involved.

CONCLUSION.

The decision of the Court below is correct. There is no conflict of decisions. It is respectfully submitted that the petition should be denied.

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April, 1931.